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UNCLAS SECTION 01 OF 04 ASUNCION 000621

SIPDIS

STATE FOR WHA/BSC, WHA/EPSC, EB/IFD/OMA
STATE PASS TO USTR FOR SCRONIN, LYANG
USAID FOR AA/LAC ADOLFO FRANCO
TREASURY FOR OSIA MAUREEN WAFER
COMMERCE ITA SARAH COOK
NSC FOR MIKE DEMPSEY
SOUTHCOM FOR POLAD
US SOUTHERN COMMAND MIAMI, FLORIDA

E.O. 12958: N/A
TAGS: ECON EFIN ETRD PINR PA
SUBJECT: PARAGUAY: IMF MISSION BRIEFS AMBASSADOR

¶1. Summary: On May 3, the Ambassador received the visiting IMF team, here for the fifth review of Paraguays Standy-by Arrangement. The program remains on track quantitatively, but faces some continued delays on the structural reform front. The Mission Chief was not overly concerned since, in his opinion, the GOPs reform program was overly ambitious. The team commented that,
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according to Finance Minister Borda, his relationship with President Duarte is better than ever. Borda appears to be keeping the fiscal deficit in line with program targets despite the large deficit implicit in the budget approved by Congress. The team was pleased with the nomination of an IMF economist, Monica Perez, to take over the Central Bank, and expressed their belief that relations between Perez and Borda will be excellent. The financial sector remains reluctant to lend, in part due to very low recovery rates on bad loans driven by poor regulation. The team felt that the key to increasing Paraguays growth is robust structural reform and positioning the country as a low-cost supplier for Mercosur. The team was concerned about a threat received by the IMFs technical advisor to Customs, which caused him to depart the country. End Summary.

¶2. On May 3, the Ambassador hosted at his residence the visiting IMF delegation, led by new mission chief
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Alejandro Santos. The two-week mission to prepare the fifth review of Paraguays Stand-by Arrangement is due to conclude around May 11. IMF resident representative Luis Duran, DCM, USAID Mission Director and Economic Counselor also attended. During the wide-ranging discussion the team expressed satisfaction with the GOPs sound macroeconomic management, but noted that significant structural reforms will be necessary to break Paraguay out of its low-growth doldrums.

BORDA, THE PRESIDENT AND THE BUDGET

¶3. The Ambassador asked Santos about how he saw Bordas standing with President Duarte. Borda told the team that his relationship with the President has never been better. Neither Duran nor Santos said they saw any signs of micromanagement on the part of President Duarte, who appears to have delegated significant authority for economic policy to Borda and the rest of the Economic Cabinet.

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¶4. The team was cautiously optimistic that Borda, whom they characterized as extremely cautious with spending, could succeed in meeting the program target of a small (half percent of GDP) deficit this year, despite the unrealistic budget passed by Congress with its implicit 2.5% of GDP deficit. The two principal tactics are the use of a financial plan (provided for in Paraguayan law to more closely align revenues and expenditures) and the Ministry of Finances Central Unit for Public Investment (UCIP) to control public investment. The latter should be fairly easy according to the team, since capacity constraints make it difficult to effect budgeted investment in any case. The first quarter results were quite strong, with an overall surplus, suggesting that Borda is on the right track.

ON AN IMF ECONOMIST AS THE NEW CENTRAL BANK PRESIDENT

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¶5. Monica Perez, President Duartes choice to succeed Gabriel Gonzalez as President of the Central Bank (BCP),

is an IMF economist who most recently worked on the Nicaragua team. The team was naturally pleased, and in fact honored that one of their own was chosen to lead the BCP. Duran said he knew her and Santos said she is a top notch economist. Santos said her relations with Borda are excellent as far as they know. While Perezs family has a personal relationship with the Presidents family, all agreed that her selection was a significant signal from President Duarte about his commitment to sound economic policy. He had a universe of options, including non-technical political allies, but chose an IMF economist, despite the existence of factions that view the IMF as a problem for Paraguay.

FINANCIAL SECTOR ISSUES

¶6. Financial sector intermediation remains a problem for Paraguay. Real interest rates remain extremely high, and
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despite the macroeconomic stability in Paraguay and the region in recent years, financial sector demand for liquidity remains strong. In response to the Ambassadors question about the possible effects of rising global interest rates, the teams financial sector expert downplayed the impact. With real interest rates so high, some increase in global rates will probably not have a major effect. Financial institutions are driven more by sentiment, and many firms self-finance, even now.

¶7. A Financial Sector Assessment Program (FSAP) team visited Paraguay in late April and found significant legal problems related to collateral recuperation. Impediments are such that banks can expect recovery rates near zero in most cases, a factor that clearly contributes to banks reluctance to lend. Santos commented on the need to create a capital market. Most bonds remain paper-based, to include paper coupons that must be signed by Minister Borda himself. Santos cited
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the dematerialization of bonds (allowing book-entry issuance and trading of bonds) as a priority to deepen local capital markets. Note: bond dematerialization is a priority of Treasurys Resident Debt Advisor. End note.

¶8. When asked about the regulation of cooperatives, now overseen by the National Institute of Cooperatives (INCOOP) rather than the Superintendent of Banks as originally preferred by the IMF, Santos remarked that there is always room to improve. Nevertheless, INCOOP has been willing to work with the World Bank and a global organization of credit unions and is improving. The Fund noted that the top 5 cooperatives have about 80% of the cooperative sectors assets, making it possible to minimize the systemic risk by focusing on a relatively few institutions.

STRUCTURAL REFORMS

¶9. Santos was relatively sanguine about structural reforms, remarking that they have their own pace and given their long-term focus, delays of several months are
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understandable and not deleterious. He acknowledged, though, that not all his colleagues share his view. Audits of Paraguays State-Owned Enterprises (SOEs) are behind schedule, but progressing. Delays were caused in part by resistance from the Controller General, who considered it unconstitutional for the Ministry of Finance to be undertaking audits of SOEs. Finance won the day, but the Ministry is just now receiving bids for several of the audits.

¶10. Santos also took the view that Congress ought to be respected, and its outputs accepted. If not ideal, the task is to find a way to make the best of them. The team noted that in most countries, they find themselves prodding Finance Ministers to pick up the pace, whereas they find Borda to be overly ambitious and often feel the need to inject some reality into his plans. Certain reforms, such as comprehensive banking legislation, are languishing in part because Congress has been overloaded with reform projects.

THE PATH TO FASTER GROWTH

¶11. Paraguay has stabilized macroeconomically, and 2004 was one of the best years (high growth and low inflation) in decades. However, per capita income barely improved. As the Ambassador noted, Paraguays growth rate was below the world average and significantly below the average for

Latin America. Santos remarked that stability for Paraguay isnt enough. Reform of the largest public bank (the BNF) is a top IMF reform priority, but in the teams view, structural reforms to make Paraguay attractive to Foreign Direct Investment (FDI) are the key to shifting upward the growth potential of Paraguays economy.

¶12. Privatization of the SOEs is a principal avenue for attracting FDI and the technology that would accompany it. Paraguay is poor because productivity is low and not increasing. Other examples of important issues affecting Paraguays attractiveness for FDI include a rigid labor market and judicial insecurity. The team thought that that
Paraguay should make a stronger play for secure access to the Brazilian and Argentine markets. With secure access and Paraguays lower taxes and labor costs, the country should be able to attract FDI, especially from Brazil and Argentina. Comment: Paraguayan officials and businesspeople charge that Brazil, in particular, used varied means to preclude Paraguayan exports from gaining a foothold in the Brazilian market and competing with Brazilian producers. End comment.

THREAT RECEIVED BY IMF TECHNICAL ADVISOR

¶13. The team was concerned about the recent departure of IMF technical advisor to Paraguayan Customs, Ives Soler, who is a French customs investigator. At a party on April 27, an unidentified man approached Soler and warned him he should be careful. Soler had received veiled threats in the past and, after consulting with IMF headquarters, decided to depart the country. He is not expected to return, a significant loss for Paraguayan Customs. Soler had been doing excellent work with Customs and was a colleague of Treasurys Resident Enforcement Advisor.

¶14. The team had raised the issue with Minister Borda, who promised a thorough investigation. The Ambassador urged the Fund to follow through and demand appropriate action to minimize the chances that Solers departure will be seen as a success for intimidation tactics. Santos noted that customs revenues had increased on the order of $400 million under the Duarte administration and that prices had not risen commensurately, implying a major hit to corrupt officials and tax evaders. Comment: As reform efforts take stronger hold, we may see more examples of intimidation tactics. End comment.

NEXT STEPS

¶15. Santos was vague about the prospects for a follow-on program. Borda has asked for one, but serious discussions have not yet begun, and the President has not t
yet signaled his support (nor his disapproval). Santos noted that macroeconomic stability, the IMFs specialty, has been achieved here. Nevertheless, Borda and others argue that the Funds presence acts as a catalyst for the reform process.

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